No. 78-78

In the Supreme Court of the United States

OCTOBER TERM, 1978

MARVIN E. SINGLETON, JR. AND
GERTRUDE R. SINGLETON, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

WADE H. MCCREE, JR.,
Solicitor General,
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The question presented in this federal income tax case is whether certain cash distributions petitioner Marvin E. Singleton, Jr.[1] received with respect to his stockholding interest in Capital Southwest were taxable to him as dividends, as the decision below held, or whether they were nontaxable returns of capital, as petitioner contends. The resolution of that question turns upon whether Capital Southwest had sufficient earnings and profits during the years in question so that the distributions to petitioner were "out of" its earnings and profits within the meaning of Sections 301(c)(1) and 316(a) of the Internal Revenue Code of 1954 (26 U.S.C.).

[1]References to "petitioner" are to Marvin E. Singleton. Gertrude R. Singleton is a party solely because she filed a joint return with her husband for the years in question.

The pertinent facts are undisputed and may be summarized as follows: Capital Southwest was the parent corporation of a group of affiliated corporations, including Capital Wire, and joined with its affiliates in filing consolidated income tax returns. Prior to the close of its taxable year 1965, Capital Southwest's president stated in a letter to Capital Wire that for taxable years 1964 and 1965, Capital Wire had been able to avoid federal income taxes on its income because that income had been offset on the consolidated return by Capital Southwest's losses. The letter went on to "advise" that Capital Wire—

> pay out as a dividend by March 31, 1965, an amount approximately equivalent to the Federal income tax that would be paid by you for both periods on a separate return basis, rather than paying the full amount of the tax savings up to Capital Southwest Corporation to compensate for the use of its losses in the consolidated return.

In closing, Capital Southwest's president agreed on behalf of his corporation to "reimburse" Capital Wire for any deficiencies in income taxes that might thereafter be determined against Capital Wire and "upheld by the Courts" (Pet. App. A-2 to A-3, A-16 to A-17).

The following day, Capital Wire's board of directors held their monthly meeting. According to the minutes of that meeting, the directors determined that Capital Wire had been able to achieve a "tax saving" of approximately $862,000 through the filing of consolidated returns. The directors were advised, however, that—

> although Capital Southwest Corporation was responsible for this elimination of Capital Wire's tax liability, * * * the amount of the tax saving should not be paid directly to Capital Southwest Corporation, but should be paid to all shareholders in dividend form and in such amount as the Board of Directors might establish.

The board then discussed—

> the amount of the dividend which the company should declare and it was generally agreed that this amount should bear some relation to the $862,800 tax saving accomplished by the filing of a consolidated return, with some additional amount in recognition of the company's record earnings during the current year.

The board thereupon voted to declare a March 25 dividend of $975,000, which increased its total distributions for the year to $1 million. As the principal shareholder of Capital Wire, Capital Southwest received $803,750 of this $1 million (Pet. App. A-3 to A-6, A-17 to A-18).

On audit, the Commissioner of Internal Revenue determined that the consolidated returns Capital Southwest and Capital Wire had filed for their taxable years 1964 and 1965, which had reported no taxable income and no tax liability, did not accurately reflect the earnings of the consolidated group. Although the corporations sought a redetermination of the deficiencies asserted against them in the Tax Court, that suit was settled and the corporation agreed to deficiencies in income taxes of approximately $900,000, of which approximately $755,000 was allocable to Capital Wire. In accordance with its undertaking in the letter of March 4, 1965, Capital Southwest paid all taxes allocable to Capital Wire as determined under the stipulated 1972 Tax Court decision[2] (Pet. App. A-6, A-18 to A-19).

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[2]After application of certain operating loss carrybacks, Capital Southwest was able to satisfy the compromise decision by paying

Petitioner took the position that Capital Southwest's 1972 payment retroactively reduced the amount of its earnings and profits for 1965 by $755,000 and retroactively served to transform the distributions Capital Southwest had made to petitioner from dividends to nontaxable returns of capital. The Tax Court, over five dissents, upheld petitioner's contentions (Pet. App. A-15 to A-26). The court of appeals reversed. It ruled that the dividend declared by Capital Wire was a dividend, just as it intended and declared, and thereby includable in Capital Southwest's earnings and profits. It therefore followed that the distributions petitioner received in 1965 and 1966 were taxable to him as dividends out of Capital Southwest's earnings and profits (Pet. App. A-1 to A-14).

The decision below correctly held that Capital Southwest had sufficient earnings and profits so as to render petitioner's distributions taxable dividends for 1965 and 1966. Petitioner's sole contention is that Southwest's 1972 payment for Capital Wire's tax liability served retroactively to transform the dividend it received from Capital Wire in 1965 into a tax allocation payment. But as this Court observed in *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149:

> [W]hile a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, *Higgins* v. *Smith*, 308 U.S. 473, 477 (1940); *Old Mission Portland Cement Co.* v. *Helvering*, 293 U.S. 289, 293 (1934); *Gregory* v. *Helvering*, 293 U.S. 465, 469 (1935), and may not enjoy the benefit of some other route he might have chosen to follow but did not. "To make the taxability of the transaction depend upon the determination whether there existed an alternative form which the statute did not tax would create burden and uncertainty." *Founders General Corp.* v. *Hoey*, 300 U.S. 268, 275 (1937); *Television Industries, Inc.* v. *Commissioner*, 284 F. 2d 322, 325 (CA2 1960); *Interlochen Co.* v. *Commissioner*, 232 F. 2d 873, 877 (CA4 1956). See *Gray* v. *Powell*, 314 U.S. 402, 414 (1941).

No matter what might have prompted Capital Wire's declaration of a dividend in 1965, it cannot be disputed that it chose to declare such a dividend. It did so in accordance with Capital Southwest's "advice" to it and for substantial business reasons. Under the rationale of *National Alfalfa Dehydrating*, there is no basis for recharacterizing the 1965 dividend as a tax allocation payment. Cf. *Moline Properties* v. *Commissioner*, 319 U.S. 436.

Nor should Capital Southwest's agreement to pay all taxes that might later be determined against Capital Wire for 1964 and 1965 affect that conclusion. Had no liability ever attached to this agreement, the full amount of the 1965 dividend distribution would unquestionably be includable in Capital Southwest's earnings and profits for 1965. The fact that the contingent obligation Capital Southwest assumed in connection with the dividend from Capital Wire ultimately gave rise to liability following the 1972 settlement of the Tax Court case in no way serves to reduce retroactively the amount so includable. Cf. *Estate of Crellin* v. *Commissioner*, 17 T.C. 781. None of the

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$254,565.98, of which $218,824.92 was attributable to Capital Wire's tax liabilities (R. 14) ("R." refers to the record appendix in the court of appeals).

cases petitioner cites[3] even remotely suggests that a dividend might be retroactively recharacterized by virtue of events that occur only years after the distribution is made. Indeed, such a retroactive recharacterization would undermine the annual accounting concept which is fundamental to our income tax system. See, *e.g.*, *United States* v. *Consolidated Edison Co.*, 366 U.S. 380; *Healy* v. *Commissioner*, 345 U.S. 278.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

WADE H. MCCREE, JR.,
Solicitor General.

AUGUST 1978.

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[3]Most of the cases on which petitioner relies (Pet. 14-15) (*Frelbro Corp.* v. *Commissioner*, 315 F. 2d 784 (C.A. 2); *Steel Improvement and Forge Co.* v. *Commissioner*, 314 F. 2d 96 (C.A. 6); *Jackson* v. *Commissioner*, 51 F. 2d 650 (C.A. 3); *Curran* v. *Commissioner*, 49 F. 2d 129 (C.A. 8); *Arthur R. Jones Syndicate* v. *Commissioner*, 23 F. 2d 833 (C.A. 7)) were decided before *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, *supra*. *Frank Lyon Co.* v. *United States*, No. 76-624, decided April 18, 1978, and *Helvering* v. *Lazarus & Co.*, 308 U.S. 252, upon which petitioner also relies (Pet. 8-9), involved questions concerning the ownership of property for purposes of claiming depreciation deductions. They accordingly have no application to the payment characterization issue here.